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ROLE OF THE STATE IN CREATING AN ENABLING ENVIRONMENT FOR THE PROMOTION OF ENTREPRENEURSHIP AND THE VIABLE DEVELOPMENT OF ENTERPRISES, ESPECIALLY SMEs, WITH REFERENCE TO THE FOLLOWING TOPICS:

(a) REGULATORY FRAMEWORK AND INCENTIVES STRUCTURES;

(b) HUMAN RESOURCES DEVELOPMENT;

(c) INSTITUTION BUILDING AND INSTITUTIONAL SUPPORT;

(d) THE INFORMAL SECTOR AND ITS INTEGRATION INTO THE FORMAL ECONOMY

Creating an enabling environment for the development of enterprises, particularly small and medium-sized enterprises

Report by the UNCTAD secretariat

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INTRODUCTION

1. The Trade and Development Board, by its decision 415 (XL), established an Ad Hoc Working Group on the Role of Enterprises in Development. According to its terms of reference, the Ad Hoc Working Group should analyse the relationship between the development of a domestic entrepreneurial capacity, in particular for the development of small and medium-sized enterprises (SMEs), and the development process. Particular attention should be paid to the situation of the least developed countries. Particular topics identified for analysis should include: (i) the role of the State in creating an enabling environment for the promotion of entrepreneurship and the viable development of enterprises, especially SMEs with reference to the regulatory framework and incentives structures, human resources development, institution-building and institutional support and the informal sector and its integration into the formal economy; (ii) export development and the role of SMEs, giving due consideration to the possible advantages arising from the globalization process; (iii) interactions between the development of SMEs and of capital markets and banking systems, with reference to the generation of domestic savings and access to capital markets and other sources of financing; and (iv) identification of areas where technical cooperation in support of policy development to enhance the role of SMEs could be strengthened. The Ad Hoc Working Group should provide a forum for the exchange of experiences among member States so as to enable them to draw appropriate lessons for the formulation and implementation of policies at the national and international levels and for international economic cooperation.

2. This report has been prepared by the UNCTAD secretariat in order to facilitate consideration of topic (i) mentioned above. This and topic (ii) will be considered at the first session of the Ad Hoc Working Group, scheduled to be held in Geneva from 3 to 7 April 1995. While this paper discusses general issues relating to the development of SMEs, specific issues concerning the export development of SMEs are addressed in the paper on topic (ii). The remaining two topics will be considered at the second session, scheduled to be held in Geneva from 3 to 7 July 1995. The present report draws on inter alia studies of country experiences, including those submitted in response to a questionnaire prepared by the secretariat from the following countries: Bolivia, China, Costa Rica, Ethiopia, Germany, Guinea, Kenya, Lithuania, Mauritius, Norway, Romania and Turkey.

3. The report raises and discusses major policy issues which can be the subject of useful cross-country exchanges of lessons learned and insights gained from national experiences, thus enabling policy elements to be drawn up for the formulation and implementation of policies at the national and international levels and "best practices" to be identified. In view of the links between the four topics mentioned above, appropriate references are made, although not in detail, to issues related to the other topics with a view to promoting an integrated output at the end of the process. These other topics will be treated in greater detail in other reports.

I. SMALL AND MEDIUM-SIZED ENTERPRISES IN PERSPECTIVE

4. Small and medium-sized enterprises 1/ are essential actors in the development process. Together with larger enterprises, they play a key role in mobilizing resources and allocating them amongst productive activities. They provide the main driving force behind the interrelated flows of trade, investment and technology, on which the strength and dynamism of an economy depends. The focus in this report on small and medium-sized enterprises (SMEs), does not, of course, mean that big firms do not matter. They do, and they have made a major contribution to industrialization and growth in many countries. However, a discussion of the relative merits of large and small enterprises, necessarily by industry, and of their contribution to development is outside the scope of this report.

5. SMEs derive their importance from a number of factors. Their large number (accounting for more than 90 per cent of all enterprises in the vast majority of countries) and their involvement in a wide variety of activities, ranging from providing goods and services to the poor to the manufacture and export of goods in the modern sector, give them a particular significance in economic and social development. They help to fight poverty. They provide a breeding ground for entrepreneurs. Through inter-firm networks and cooperative programmes, including with larger enterprises, they raise the levels of labour skills. Through the "demonstration" effect, they spawn new enterprises. Being labour-intensive, they generate wage and self-employment for large sections of the population. They are net job creators, even in periods of recession. They are also able to use resources that may otherwise not be drawn into the development process. By encouraging personal savings and the use of the retained savings of firms, they also play an important role in mobilizing and generating domestic savings.

6. On account of their small size, they are flexible and adaptable. They add flexibility to the industrial structure by engaging in small batch production and made-to-order or other types of "finishing" operations complementary to the activities of large-scale industry. Since innovative projects typically start small, they are also the instruments of innovation and they generate greenfield investments. And the shift towards specialization-based production, together with flexible specialization and technological changes, under the impact of globalization will further enhance their role in providing a flexible and skilled production base. At the regional level, their specialization, creativity, flexibility and mobility are seen as providing regional production networks for stimulating technological innovation and new growth and dynamism. They are in fact at the forefront of change.

7. In most countries, SMEs account for over half of the total share of employment, sales and value added (which, along with relative numbers, are the principal indicators of the importance of SMEs). In the Republic of Korea, SMEs were responsible for 80 per cent of employment created in the manufacturing industry between 1976 and 1986. In China, SMEs produce two thirds of the national industrial output. In the European Union, while larger firms have shown a net loss of jobs since 1988, small firms employing

up to 99 employees created 3 million additional jobs between 1988 and 1993, particularly in the distributive trades and other services, one third of them due to the creation of new enterprises. 2/ Although less important than in the developing countries, the contribution of SMEs to industrial employment remains significant, even in the most advanced economies.

8. Innovation is another important contribution of SMEs. Precise data is hard to gather because the traditional measures used to calculate innovation often neglect the fact that, in SMEs, the owners and managers themselves are innovators. In Japanese SMEs, 52 per cent of innovations reported originated with employers, while in large firms, 72 per cent came from technicians. However, the evidence indicates that SMEs are at least as innovative as large firms - even more so in industries dominated by large firms where SMEs need to innovate in order to compete.

9. SMEs can also play a significant role in creating balanced economic and social development in developing countries. Their potential advantages are well known. Small firms tend to use less capital per worker than their larger counterparts. Their labour-intensive character is consistent with the relative abundance of labour and shortages of capital and foreign exchange characteristic of developing economies. Small enterprises also have the capability to use capital productively. Data for Colombia, Ghana and Malaysia, for instance, show significantly higher ratios of value-added to fixed assets in small firms than in large firms. 3/

10. Perhaps most important, through that elusive characteristic called entrepreneurship, they make use of resources that might not otherwise be drawn into the development process. They generally employ workers with limited formal training, who then learn skills on the job. They are able to mobilize the small savings of proprietors who would not use the banking system but who will invest in their own firms. Experience with small firms in Indonesia, for example, shows that firm owners have a surprisingly high propensity to save and invest, even at quite low income levels. SMEs are also able to utilize scattered local raw materials that would otherwise be neglected.

11. In most countries, SMEs provide the majority of jobs, and this role may increase in importance as large firms restructure in order to specialize or concentrate on core activities, while contracting out ancillary activities and component production to SMEs. Such restructuring and contracting-out are taking place not only within national boundaries but also across frontiers, driven by the desire to reduce production costs by taking advantage of economies of specialization or of lower wage costs in other countries. By clustering together or by creating networks to promote inter-firm cooperation, together with flexible specialization involving multi-purpose machines and multiple-skill labour, SMEs can achieve scale economies similar to those of large firms. Individual firms, through flexible specialization, can also achieve scale economies at the plant level and, together with other SMEs, can achieve economies of scope. Where they are concentrated in a particular area, as in an industrial district, they can also exploit their economies of density when contracting outside services. Likewise, the size of firms is not only a

function of the industry or of the capital intensity of the production process, but also of the extent to which the industry can be organized along the lines of specialization-based production among different firms in order to achieve maximum efficiency and adaptability.

12. Thus, the role and perceptions of SMEs in the development process are changing. With the increasing shift towards task and component specialization not only within but across frontiers, and with the possibilities and economies opened up by flexible specialization, together with technological advances, including in the areas of information technology and telecommunications, SMEs are at the centre of any industrial strategy and its trade, investment and technology linkages. They also influence corporate strategy, not only of large enterprises but also of SMEs, including SME transnationals. Thus, creating a favourable environment to facilitate the development of SMEs can pay important dividends in terms of creating a skilled and flexible industrial base, developing new industries, expanding trade, generating domestic and foreign investment, and acquiring and developing technological capacity.

II. REGULATORY FRAMEWORK AND INCENTIVES STRUCTURES

A. Overall policy framework

13. Creating an enabling environment for the development of SMEs implies the creation of a favourable overall policy framework for the development of all enterprises and of entrepreneurship. Such a framework will need to create confidence among economic actors, including foreign investors, in the management and evolution of the economy and to reduce commercial, financial or investment risks associated with unexpected or sharp tax, interest rate or currency movements. Such conditions, together with fiscal incentives and financial market regulations, will help to mobilize savings, develop financial institutions and markets and encourage investment, including foreign investment. Policy instruments, including trade, monetary and fiscal policies, to achieve macroeconomic stability are thus essential. Such macroeconomic stability will also facilitate structural adjustment, including any industrial restructuring, designed to achieve more open and competitive markets, as well as to develop particular industries with a high market and export potential because of favourable demand and factor conditions. In addition, other favourable "framework conditions" will need to be created through appropriate policies, including those relating to factor markets, the organization of the firm and support services, product markets and intellectual property, environment and standards. Such policies range from price deregulation, promoting greater flexibility and mobility in labour markets, improving the overall legal framework and promoting competition to policies concerning human capital and infrastructure development. Policies to promote human capital and infrastructure development, including the private development of infrastructure, are particularly important, especially in the least developed countries. Unfortunately, such budgetary expenditures are often cut in the context of structural adjustment or stabilization programmes.

B. Regulations and incentives

14. One of the most important issues concerning the creation of a favourable overall policy framework is the improvement of the legal and regulatory framework in which SMEs operate. This may involve removing or easing regulatory constraints, as in many developed and developing countries, or improving the overall legal framework governing business activities, as in many countries in transition. Regulatory constraints act on SMEs in different ways, for example by imposing barriers to entry on their operations (thus restricting competition) and by imposing a cost for business start-ups and development. On the other hand, inconsistencies and gaps in the overall legal framework can also act as constraints on SME development. A recent study stated that government barriers to competition rather than labour market rigidities explain why recent employment creation has been lower in the European Union than in the United States and Japan. 4/ It has been noted that, in Italy, the absence of Government involvement in the development of SMEs (other than recent legislative measures to reduce restrictions on small firms), together with a policy of not actively levying taxes and payments of national insurance contributions on such firms, has created a considerable degree of independence and self-reliance among SMEs and fostered rather than hindered their development. 5/

15. Regulations and incentives are interconnected. For example, regulations to restrict or to sequence the entry of participants to a particular industry, as have been applied, for example, in Japan and the Republic of Korea, in order to achieve scale economies, to avoid excess industry capacity and to create rents to finance productivity improvement and technological innovation as part of the catching-up process of late industrializing countries are a form of selective intervention. However, by staggering entry of firms (one or several at a time), they also serve as a form of policy-induced incentives to firms to compete to be among the first entrants to the industry or to join it at a subsequent stage. The industry members also have an incentive not to grow fat on their rents or to become complacent because there is always the threat of competition from new entrants (a market-based incentive), including through trade liberalization (whether controlled or not). However, such selective interventions can fail. For example, industrial promotion policies, particularly those designed to encourage small-scale industry through market reservation of products, as for example in the textiles industry in India, have tended to promote inefficiency in the industry, while discouraging capacity creation in, and competition from, large-scale industry. In India, applied indiscriminately, whether or not the products of the small-scale sector were competitive or not in terms of cost and quality, such a policy produced a situation where the small-scale sector could not stand on its own feet, while the mill sector of the textile industry and its exports were seriously affected. 6/ Thus, policy-induced incentives may need to be accompanied by market-based incentives or by "functional interventions" designed to promote competition (or the threat of competition) and the efficient development of the industry. It has been observed that, in the Republic of Korea in the 1980s, a two-track liberalization policy was pursued, with slow-track liberalization for advanced-technology products and fast-track liberalization for industries that had become internationally competitive. 7/ Further, in Japan, in order to build up industrial backward linkages, "policy-based" finance was provided, for example, to SMEs to compensate for their lack of access to private-sector financial institutions. At the same time, measures were taken by the Japanese Government in cooperation with the firms concerned, in the context of "industrial rationalization", to reduce production costs and to increase productivity in the particular industries, based on the concept that "all aspects of a firm in any given industry have to be rationalized if the firm is to compete with other firms and survive in domestic and overseas markets". 8/

16. To take another example, it has been argued that trade policy reforms in terms of trade and of exchange rate liberalization (i.e. currency depreciation) can help developing countries, including the least developed among them, to diversify production and exports. However, a study of 22 least developed countries has shown that there is no hard evidence to establish this relationship; the study in fact indicated that real currency appreciation for four of them had led to better export and general economic performance. Further, it concluded that, for countries with little or no industrial capacity, specific measures to increase supply capacity would seem to be more important than trade policy reforms. 9/ However, the above arguments about the use of market-based incentives or "functional interventions" to promote efficiency, in addition to policy-based incentives, are still valid.

17. Export processing zones (EPZs) provide another example of how both types of incentives can be used to good effect, with policy-induced incentives being used to attract firms to the zones and market-based incentives encouraged in order to spur firms to greater efficiency. The policy-induced incentives provided by the Government of Mauritius for the EPZ include: exemption from import duty on plant, equipment, spare parts and raw materials for EPZ firms - probably the most effective of the incentives; payment by EPZ firms (and registered SMEs) of a nominal rate for many corporate taxes during the company's life; loans at preferential rates of interest for EPZ firms (and registered SMEs and other priority sectors); and ready-made factory space or service sites at preferential rates in the industrial zones. 10/

C. Government-business consultative mechanisms

18. Another aspect of the Asian experience is the role played by deliberation councils and other similar arrangements in various East Asian economies in promoting Government-business communications and cooperation and in obtaining inputs from the private sector for official policy-making. 11/ Such deliberation councils have been established in Japan and are of two types: functional (for example, pollution or finance) and industry-specific (for example, automobiles or chemicals). Each council provides a forum for government officials and representatives from the private sector - business, labour, consumers, academics and the press - to discuss policy and market trends and generally to exchange information. Government officials conduct hearings with interested parties, undertake research and prepare reports for the appropriate deliberation councils, where policy negotiations may take place. The reports are revised in the light of the deliberations and released to the public to explain the objectives of the new policy. Final approval by Parliament is usually routine. Industrial associations have been important participants in the consultative process. In many cases, these associations are empowered by law to represent their sectors.

19. In the Republic of Korea, government-business consultations have also been used to solicit businesses' views on such matters as markets, regulations and potential plans and to include them as a critical policy component. These consultations are basically of two types: functional (for example, taxation) and sectoral (usually focused on a particular industry). Government officials also play an important role, as in the Japanese system.

20. In Malaysia, formal government-business consultations have been essentially functional, focusing on issues like the budget and trade. The pinnacle of the consultative structure is the Malaysian Business Council, created in 1991, which is chaired by the Prime Minister himself and which includes more than 60 members from the Government, industry and labour. The MBC resembles the Republic of Korea's highly successful Export Promotion Council.

21. In Thailand, top government officials, particularly from the economic agencies, meet with business leaders from the chambers of commerce and industrial and bankers' associations in a national consultative committee, chaired by the Prime Minister himself. Provincial consultative committees have also been established to supplement the national committee.

22. In Singapore, the private sector, through its participation, for example, in the work of government statutory boards and ad hoc Government Advisory Committees, helps to review policies and programmes and to make recommendations for official consideration. In addition, the Government regularly invites chambers of commerce, trade associations and professional societies to submit their views on specific issues. A tripartite National Wages Council, including representatives from the Government, business and labour, has been established which fulfils several coordination functions, while simultaneously furthering business-labour cooperation.

23. From an economic standpoint, deliberative councils facilitate information transmission. They enable the bureaucracy to gather information about world markets, technology trends, and the impact of regulations domestically and abroad, synthesize the information into an action plan, and communicate the plan back to the private sector. An efficient and reputable bureaucracy is thus essential for success. Self-interested business behaviour is more or less constrained by the repeated nature of the collaboration. This in part helps to establish credibility - private sector participants believe cheating and reneging are less likely. Politically, these councils serve as proto-democratic institutions, providing direct channels for big business, labour and academia to the seat of power. Finally, because the rules that govern an industry are effectively established within the council, every member is assured that the rules cannot be altered arbitrarily. With clear rules established, members can concentrate on market competition and not worry about others trying to curry special favours from the Government. In effect, their share of industry profits is determined more through competition than through rent seeking. In this sense, a deliberation council can be viewed as a wealth-sharing mechanism. It can also help to promote growth with equity, a particularly important objective for multi-ethnic societies.

24. The importance of deliberation councils can also be viewed from the perspective of their role in strengthening the quality of government-private sector cooperation. Given the many areas where there is a mutual interest in such cooperation, including, for example, skills, technological and infrastructure development, environmental protection and the promotion of inter-firm backward and forward linkages, the ability of the Government and the private sector to build up a confident and effective working relationship with each other assumes particular importance. Recognition of this has also been reflected in a less confrontational stance between the Government and the private sector in many countries. The quality of such a working relationship, as an economist has remarked, might be a competitive advantage for a country in its own right. 12/

III. INSTITUTION-BUILDING AND INSTITUTIONAL SUPPORT

A. The process of policy development and institution-building

25. Governments are conscious of the importance of SMEs not only for national development but also for regional cooperation. Some countries such as Indonesia and France have Ministries of SMEs, and the European Commission has a Directorate overseeing the development of SMEs. However, it is not always evident that the process of policy development in support of SMEs in individual countries responds effectively to the needs and concerns of SMEs or takes sufficiently into account the difficulties or constraints faced by them. This is partly a problem of the lack of effective representation of SMEs in the process of government policy-making. SMEs in fact often complain that, though they are in the majority, they have a minority voice in influencing policy development concerning SMEs. The problem is also partly one of a lack of focus or of an integrated policy framework due to a multiplicity of official institutions dealing with SMEs, each pressing its own claims or vested interests. It is also partly a matter of the Government trying to pursue conflicting objectives, giving priority to job creation or poverty alleviation over enterprise development or attempting to do too much with too few resources, ignoring the role of private sector initiatives at different levels in assisting SMEs through inter-firm or market networks.

26. Thus, if policy development in support of SMEs is to be effective, the process has itself to be improved so that it becomes more coherent and more responsive to the real needs and concerns of SMEs. For this purpose, adequate research needs to be carried out - a matter that is receiving increasing interest and support in the donor community - on a profile of the SMEs and their particular needs and concerns. Targeted assistance is needed if it is to be effective, and it can only be targeted if the government agency knows who the SMEs are and what their real needs and problems are. This lack of a clear knowledge about SMEs seems to be prevalent in many countries. Such research on SMEs will have to take into account the diversity of firms involved and the types of problems faced by different categories of SMEs, ranging from subsistence or income-supplementing micro-enterprises operating in the informal sector to internationalized, technologically advanced SMEs. For example, for subsistence micro-enterprises which have no ambition to graduate to the formal sector, the biggest problem may be access to adequate finance or other essential inputs rather than business regulation which may not be strictly enforced as far as they are concerned. On the other hand, for those SMEs operating in the modern sector which are motivated to grow or to expand their operations overseas, they may be more interested in tax incentives, market and investment development assistance, export financing or trade fairs.

27. As regards the question of obtaining inputs from SMEs for policy development, Governments may need to encourage SMEs to organize themselves for this purpose, if they have not already done so, and to ensure that their representatives are well represented in government-business consultative bodies, such as business or deliberation councils. In Taiwan, Province of China, consultation and coordination with SMEs is facilitated by middle- and lower-level officials of the Industrial Development Board, who make routine, informal visits to thousands of SMEs within their jurisdictions.

28. As to the question of institution-building for policy development, there is much to be said for establishing a central development authority to oversee the development of SMEs. Most Governments have in fact established such agencies, which can take different institutional and organizational forms. Some are parastatals, such as the Small Industry Development Organization in the United Republic of Tanzania and in Zambia. Some others operate as part of a Ministry, such as the Small Industry Support Programme in Indonesia and the Industrial Development Board in Sri Lanka. Their functions also vary but seem to include several of the following: policy development, research, administration of assistance programmes (finance, training, marketing, advertising and other services) and management of industrial estates.

29. Such development agencies have been critized for their bureaucratic nature, the absence of performance criteria for judging or stimulating their performance and their lack of effectiveness in responding to the needs of SMEs. 13/ Salaries have usually been too low to attract or keep experienced staff. Further, the rapport between staff and client has often been weak, stemming partly from the civil servant's traditional distrust of the "free-wheeling" entrepreneur and the businessman's fear of a government official prying too closely into his business affairs. Another particular criticism is that, given the heterogeneity of SMEs, it is virtually impossible for the agency to encompass the range of expertise needed in a single institution. However, these criticisms are not sufficient arguments for doing away with such agencies. Rather they are arguments for improving their organization and functioning. Such improvements may include refocusing their role on essential functions like policy development, streamlining their organization and attracting better qualified staff, supplementing or supporting private sector activities in areas where the private sector has better expertise rather than duplicating them, and coordinating with specialized institutions in the provision of specialized services to SMEs. Such institutions may need to be established in areas like automation, productivity improvement, standards and industrial research, and science and technology (as in Singapore). In Taiwan, Province of China, the Government has also established an institute for the information industry in order to promote that industry. These specialized institutions may also be linked to research programmes of universities. Apart from undertaking research on particular industrial technologies or industries, including their human resource development implications, they can help to disseminate information where inter-firm networks may be deficient, for example due to foreign firms being unwilling to share critical information with local companies. Thus, the central development agency and specialized institutions may help to compensate for "market failures". However, they need to be properly staffed and motivated, so as to avoid "government failures".

30. In 1991, in an ILO study, a number of recommendations were made on strengthening SME institutions. According to the study, the lessons drawn from international experience with handicraft/small-scale industry development programmes over the past 30 years suggest that certain broad principles should be borne in mind when designing or restructuring institutional arrangements for the support of these sectors. These broad principles include: 14/

(a) All types of products and sizes of unit falling within the handicraft and small-scale industry sectors should be integrated under the same organization or institutional mechanism. This should encompass part-time cottage workers and "modern" small enterprises, hand as well as mechanized production processes, utilitarian and artistic products. The reasons are straightforward. In practice, it is difficult to differentiate between utilitarian and artistic products. All small-scale producers face similar problems. The growth of individual units should be encouraged and economies of scale fostered. Organizational staff should be familiar with different types and categories of products and enterprises if they are to facilitate a dynamic evolution in the sectors they are serving. The structure and composition of the industrial sector need to respond readily to changes in technologies, market demand and available resources;

(b) Government organizations should be financed from taxes or levies, not from income generated by commercial production or marketing activities. If such organizations engage in commercial activities, they undercut or pre-empt opportunities for private enterprises in the same sectors, and hamper the development of market network relationships with firms in other sectors. If they can draw upon government grants as well as income from their own commercial activities, these activities are invariably subsidized. Subsidies accentuate the negative impact on competing private enterprises which must cover the full costs of their operations;

(c) Government organizations cannot be established throughout the country to directly serve/assist hundreds of thousands of workers employed in small firms. This would require many thousands of government officials and risk duplicating the activities of the private sector (wholesalers, retailers, equipment suppliers, accounting and consulting firms, advertising agencies, etc.) which is currently helping small-scale producers to overcome specific technical and managerial problems and meet particular market needs. Thus, such organizations should promote rather than substitute services flowing through market linkages. They should mostly play a catalytic/promotional/analytical role and use their administrative and organizational skills to bring private parties together and strengthen the complementary relationships between them;

(d) Efficient quality services require highly qualified and motivated staff. Government organizations subject to civil service salary structures, personnel practices and bureaucratic procedures cannot attract, retain and motivate such staff. Experience suggests two solutions. One, their need for staff could be reduced by transferring activities to the private sector, as indicated above. And two, agencies with a larger degree of financial and managerial autonomy could be established and performance-related incentives for staff introduced;

(e) Assistance of a "social welfare" nature should be separated from activities to promote the growth and profitability of enterprises that will contribute to economic development. Combining the two objectives tends to result in conflicts of interest, contradictory or confused signals to clients and inefficient use of resources. If Governments wish to subsidize the activities of disadvantaged groups on social grounds, it is better to pay these subsidies directly to targeted beneficiaries in the form of grants, tax

credits or vouchers, rather than to subsidize government organizations providing supporting services to a wider range of clients, including more affluent entrepreneurs. Direct subsidies ensure that the benefits reach the target groups only. They can determine their own priorities. They can use their grants, tax credits or vouchers to buy the inputs they really need from the most efficient suppliers;

(f) The private sector should be represented on the boards of government organizations by experienced entrepreneurs/managers elected by independent associations of employers and craftsmen, not by political nominees. This helps to ensure that the beneficiaries, and the private sector more generally, have an adequate voice in the way these organizations are run.

31. For the reasons stated above, there is merit in establishing a single, autonomous, national SME development agency with full representation of the public and private sectors. Where there is a multitude of SME support or development agencies, it can group their functions within an integrated policy framework. The main functions of the agency would need to include: (i) research, policy analysis and development, including establishing a profile of SMEs and researching and monitoring the impact of policies on SMEs, in order to provide policy inputs and to act as a catalyst for improving the policy, legal and regulatory environment in which SMEs operate; (ii) administering the Government's SME financial support schemes and common facilities for SMEs; (iii) building up local business capabilities, in cooperation with the private sector and with specialized institutions such as those dealing with productivity improvement, quality control, standards and industrial research and export development; (iv) promoting inter-firm linkages, including the establishment of a subcontracting exchange; and (v) communicating with the public on SME development policies and efforts, working also with NGOs and their networks, particularly at the grassroots level, in order to reach as wide an audience as possible.

32. In respect of various other functions (information, business advice and assistance, training, research and monitoring of developments, exhibition and promotion, local industry upgrading, etc.) it should ask, in each case, whether, in the light of the Government's objectives (including that of promoting growth with equity) and of the capabilities and characteristics of the private sector, the function might be better performed by private intermediaries through market networks (if necessary, with the help of incentives or financial assistance), by appropriate cooperative arrangements with the private sector or by its own direct intervention. This would allow the development agency to focus on its priority functions, while permitting private sector expertise and market networks to play their full part in providing support services to SMEs. In adopting a "one-stop" approach to the delivery of various related services, care will have to be taken to ensure that the staff is fully qualified and that the services are based on timely and specific information; otherwise, it will not serve its purpose. However, in countries where business support services normally provided by the private sector are not fully developed, as in many countries in transition, the long-term solution is not to provide such services but to encourage and support their development. Additional measures may be needed for this.

Information and advisory services, for example on business start-ups and planning or on new developments in technology, market opportunities, legislation, etc., have been particularly mentioned in country contributions.

33. The development agency, with a streamlined organizational structure and accountable to a high-level Board, with both public and private sector representatives and chaired by the Minister concerned, might be financed from a mixture of sources - the central Government, international donors and the private sector through, for example, a levy on enterprises or user charges. User charges would have the merit of gauging the value of the services provided.

B. The substance of policy intervention and support programmes

34. SMEs seem to emerge in almost any sector in response to unmet needs of the public or other firms, where there is ease of entry, an absence of pronounced economies of scale in that line of activity or a positive advantage of being small. They may also be spawned by large enterprises wishing to benefit from the scale economies of flexible specialization.

35. However, though they are born easily, their mortality rates are high. For example, in Singapore, between 1983 and 1990, the annual attrition rate for all enterprises (of which roughly 90 per cent are SMEs) was 15,000, as against an annual establishment rate of 21,000, leaving a net annual addition of 6,000 enterprises. 15/ To some extent, the failures of small firms are a healthy sign in a dynamic economy; uneconomic or inefficient enterprises should find it difficult to survive. Not all budding entrepreneurs have what it takes to build up their businesses and survive in a competitive market. Economies of scale and comparative advantages change over time as new technologies appear, incomes rise, infrastructure improves, skills develop and markets expand. But in many cases failures, or retarded development, of firms are caused by an unfavourable economic climate. Starved of investment capital, ignored by banks, overlooked in development plans and neglected by foreign aid programmes, SMEs have often had to rely on internally generated funds for expansion and modernization. To compound the problem, their profitability and incentive to invest are often undermined by both overt and hidden subsidies to large-scale industry.

36. Moreover, the numerous regulations that affect markets in developing countries often tend to encourage small firms to develop uneconomic ratios of capital to labour. Small-scale enterprise is typically labour-intensive, and this is usually a desirable characteristic in developing countries. Some countries have even promoted small firms as proxies for government-sponsored programmes to provide employment or to fight poverty. The low capital intensity is often, however, accentuated by government-induced distortions, with undesirable effects on efficiency and income levels.

37. In many developing countries, the markets for capital, foreign exchange and labour are affected by numerous types of regulation, subsidy and taxation. Most small firms have very limited access to foreign exchange and to bank and institutional credit, whereas they can usually draw upon a large reservoir of cheap unemployed or underemployed labour. The result may be capital/labour ratios that are so low as to result in very low labour productivity in many

small firms. Large firms, on the other hand, may be allocated investment funds at negative real interest rates and may be provided with foreign currency at artificially low exchange rates. This encourages them to be profligate in their use of capital. Moreover, trade union pressure and labour legislation (which usually cover only the modern sector) may require large firms to pay relatively high wages which, in turn, may induce excessive substitution of capital for labour.

38. The net effect can be the worst of both worlds - technically backward production methods and depressed incomes in small firms, where the majority of the labour force is employed, and excessive use of capital in the modern sector, which receives the bulk of the investment funds but creates few jobs. A dualistic structure results, inimical to both efficiency and equity.

39. While inappropriate regulation may distort their structure, it is also clear that specific government measures of support to small firms may, unless carefully designed, prevent their efficient operation or have the opposite results. For example, imposing a low interest rate ceiling on loans to SMEs can lead to credit rationing in the face of excessive demand and to abuses in the allocation process. It can also deter commercial banks with no access to subsidized funds from providing loans to SMEs, leading to a contraction, rather than an expansion, of the supply of credit to them. Where selective controls have been used to protect small firms from competition, they have sometimes backfired. For example, in some countries, licences for the production of products such as cotton textiles are confined to small firms using traditional handicraft techniques. Technological development and adaptation have thus been discouraged, and consumer demand has switched to more competitively priced or more "modern" synthetic textiles made in larger enterprises not subject to such controls. Incomes in the protected sectors have consequently declined or remained stagnant. Similarly, attempts to protect the livelihood of taxi operators or small traders by restricting the number of licences issued have sometimes led - through the corruption of public officials - to these activities being controlled by larger operators or by particular ethnic groups.

40. Much remains to be learned about how to create effective support programmes for SMEs. There are no simple answers, let alone generally applicable solutions, given the diversity of SMEs and country situations. However, some general principles may be identified in defining an overall policy framework for the development of programmes in support of SMEs.

41. Firstly, the support programmes should be market-based. In other words, they should tap and build on the expertise, capabilities and resources available in the private sector and thus complement rather than duplicate them. For example, in designing skill development programmes, private sector leaders and experts should be consulted on the types of training programmes needed and how best they can be organized and delivered, for example within firms, by a business organization or by the development agency itself. The approach will obviously depend on the level of development of market institutions or networks. In many countries in transition, for example, where market mechanisms and business support services are relatively weak, the agency may have to assume a more important role, with outside help, if necessary, until private sector capabilities are developed. Further, in those

countries, the training of trainers, for example of business and management skills, may be needed in order to create the necessary multiplier effects in a vast programme of capacity-building for business development.

42. Secondly, priority would need to be given to improving the policy, legal and regulatory environment in which SMEs operate. This would imply, among other things, reducing subsidies and other policy measures which favour large enterprises and discriminate against SMEs, simplifying regulations and administrative procedures for business start-ups and development and enacting new legislation to deal with gaps or inconsistencies in business laws. In the final analysis, improving such an environment may be more beneficial for SME development than specific support programmes. In Norway, the Government, recognizing the constraining nature of the regulatory environment for business development, has established a Business Legislation Committee to review on an ongoing basis the regulatory framework and make proposals for simplified administrative rules and other changes for stimulating business activity. In addition, a new Competition Act has been enacted to enhance competition. 16/ In China, the very act of deregulating employment by allowing self-employment has released the floodgates of entrepreneurial energy and led to a rapid growth of SMEs established by peasants and urban dwellers. Other measures in China include the simplification of registration procedures for commercial and industrial enterprises and the relaxation of State controls on mineral resources (for example coal). These have led to the establishment of SMEs not only in commerce and services, but also in industry and mining (with small rural and town collieries accounting for one-third of total coal output). 17/ Thus, improvements in the regulatory framework, stressed in practically all the country contributions, can by themselves serve as policy induced incentives to SME development. By opening up markets to competition, they also encourage the operation of market-based incentives.

43. Thirdly, attention would need to be given to enhancing the availability and efficient utilization of essential inputs commonly needed by SMEs, including finance, land, physical facilities and equipment. This would imply, among other things, improving SME-targeted credit facilities by the agency and by agency-supported private intermediaries, changing zoning regulations that tend to restrict the access of SMEs to well located sites, providing common facilities and making equipment and spare parts more readily available to SMEs. Efficient utilization of inputs can help to reduce costs and may be as important as financing costs.

44. Fourthly, attention would also need to be given to promoting inter-firm linkages among SMEs and between them and larger firms so as to increase the skills, business information and production, marketing and sales opportunities of SMEs through inter-firm and market networks. This may require, among other things, establishing a subcontracting exchange and having the SME development agency work closely with the investment promotion agency with regard to inter-firm linkages with foreign firms.

45. Significantly, where SMEs have flourished, it has often been in countries where governments have encouraged relatively open and competitive markets. In such an environment, firms in the same line of business compete with each other on a more equal footing. Just as important in this environment, firms in different fields can form complementary relationships. Where

interdependence between suppliers and customers is allowed to develop freely, many of the supporting services will be provided by other firms and will no longer need to be provided by the government. The larger firms which depend on SMEs to become efficient suppliers of specialized components or services for their production processes will themselves have the incentives to provide technical help and training to the SMEs in order to increase their efficiency. In Taiwan, Province of China, large firms have provided trade credit and large-scale loans to their SME partners, thus partially offsetting the discriminatory impact of government-induced distortions in the financial markets. 18/ Studies of African and other countries show that inter-firm or market networks have helped to provide business support services highly valued by SMEs. 19/

46. One question concerning such support programmes is whether they should be applied to all enterprises, regardless of size, or whether and to what extent they should be targeted at SMEs. There seems to be some justification for arguing that a "level playing field" should be created for all enterprises, regardless of size, and that, if policy interventions are needed, they should be directed at eliminating the bias in favour of large enterprises, for example subsidized credit or special foreign exchange allocations for such enterprises, rather than being packaged specifically for SMEs. In other words, the policy should be one of promoting "maximum openness, minimum intervention", the argument being that preferential treatment for SMEs can distort the incentive structures inherent in open and competitive markets and thus lead to inefficiencies. It follows that any bias in favour of large enterprises or any market distortions against SMEs will need to be removed so that SMEs can compete on equal terms.

47. However, in practice, things may not be that simple. For a start, many SMEs, notably small and micro-enterprises, may not be able to compete on equal terms, particularly with regard to access to finance or information, and some specific additional measures may be needed in order to help them. Even where such support programmes are intended for all enterprises, as in Singapore, they started as SME-targeted programmes; the coverage has been widened by raising the eligibility threshold because of the need to respond to the requirements of growing local enterprises. Further, if public administration is poor or corrupt, if lump-sum taxes or licence fees are high or if the cost of capital is high or often at the mercy of bad macroeconomic management, the cost of administrative compliance or of raising working capital will be disproportionately higher for SMEs than for large enterprises. They may prove to be prohibitive or even fatal for some SMEs. Thus, the case for creating a "level playing field" will need to be examined with a view to achieving a really level playing field, so that SMEs are not disadvantaged because of their small size. This means, among other things, that administrative procedures for the licensing of companies or for the approval of factory plans or land sites should be simplified and be devoid of excessive administrative discretion (thus reducing the scope for administrative abuses) and that the administration of support programmes for enterprises be handled by efficient public officials in an open and non-discriminatory manner.

48. In Singapore, there are over 60 support programmes for enterprises, regardless of size. These provide support for various stages of enterprise growth, from start-up to expansion to overseas activities. They range from

low-cost financing, tax incentives, business development, marketing, design, technology adoption, standards upgrading, productivity improvement and computerization to expanding operations abroad (see table 1). These support programmes are coordinated by the Economic Development Board (EDB) through its Enterprise Development Division, upgraded from a Small Business Bureau as its activities expanded to keep up with the growth of local enterprises, both in size and in number. These support programmes underpin a multi-agency approach, which facilitates coordination, and are administered by the EDB itself or in cooperation with one or several specialized institutions dealing respectively with, inter alia, automation applications, science and technology, information technology, productivity promotion, trade and computerization, as well as standards and industrial research (which also provides incubation facilities for start-up companies). In the case of the last two areas, support is provided independently by the specialized institutions or by them in association with universities.

49. The following section gives some guidelines which might be taken into account in designing various support programmes. 20/

50. **Credit.** The availability of credit to small firms can often be increased by removing - or at least raising - interest rate ceilings and permitting a "spread" that makes it worthwhile for banks to lend to small businesses, or by increasing the number and range of intermediaries allocating foreign exchange for investment. A refinancing facility can be useful, as can credit guarantee schemes (with costs passed on to borrowers) and training of local bank staff in simplified project appraisal and supervision methods. As a general rule, the management of credit programmes should be left to specialized financial institutions. Assistance may be provided to small-scale producers to prepare and present credit applications to banks, but the risks must be borne by the two parties to the credit transaction. Savings may be mobilized by setting positive real interest rates on deposits. Borrowers need to be charged positive real interest rates in order to encourage an efficient use of capital, deter a corruptive manipulation of subsidized funds and improve access to credit for those who can use it effectively.

51. Fiscal incentives. Fiscal incentives can be used creatively to promote priority sectors or to enhance the development of particular regions, including through foreign investment. In the case of such incentives to promote foreign investment, there is a need to avoid competitive bidding, enhance information exchanges and promote transparency in order to avoid abuses or reduce unnecessary costs.

52. Imported raw materials. Reform of trade regimes may be necessary in order to remove abuses of the import licensing system. It is not uncommon, for instance, for middlemen to find their way onto the allocation lists and then to resell their supplies at black market prices to small firms that desperately need imported inputs to survive in business but lack influence over the licensing authorities. Freer access to foreign sources and lower levels of protection for domestic alternatives would be desirable.

Table 1: Assistance programmes for different stages of enterprise growth in Singapore

Start-up	Growth	Expansion	Going Overseas
Computerization	ISO 9000 certification	Automation leasing	Business development
Finance	Computerization	Brand development	Double deduction for overseas investment
Product development	Finance	Business development	
R&D incubator	Technical assistance	Franchise development	Franchise development
Skills Development Fund	Industry upgrading	ISO 9000 certification	Finance (overseas)
Venture capital	Market & investment development	Computerization	Industry upgrading
		Finance	
	Product development	Technical assistance	Market & investment development
	Pioneer status/ investment allowance	Industry upgrading	
	Skills Development Fund	Market & investment development	Overseas enterprise incentive/ overseas investment incentive
	Software development assistance	Pioneer status/ investment allowance	
	Venture capital	Product development	
		Skills Development Fund	
		Software development	
		Total business plan	
		Venture capital	

Source: Growing with Enterprise - a National Effort, Economic Development Board, Singapore, 1993.

53. **Labour markets; skill and management training.** The objective is to increase labour skills and mobility by supplementing on-the-job training and by reducing labour market rigidities (particularly those affecting wages) which prevent the free flow of workers. Useful advice and assistance in training can often best be provided by the suppliers and customers of small firms, but governmental vocational training programmes can also be adapted to SME needs and circumstances (through such media as mobile demonstration units and night schools). Such programmes need to focus on scarce skills which face growing market demand; this requires manpower projections based upon reliable statistical information on past and current trends in different occupational groups. In-firm training may be encouraged through fiscal incentives, grants and stipends to cover part of the costs imposed on entrepreneurs in inculcating and upgrading craft skills; however, there is a need to avoid too generous subsidies which encourage entrepreneurs to use apprentices as cheap labour and then unload them onto a saturated market when the payments stop. The self-employed and the owners of small firms may be helped to acquire the basic management techniques to run their businesses, rather than trying to change people's personal drives and behavioural characteristics. Input suppliers are often willing to show their customers how to get the most out of their equipment and materials; such training is effective because it is linked to specific materials and equipment, and to particular products made in a market environment, not just an abstract exercise. To the extent possible, the choice of candidates for training will have to take into account the need to promote social mobility, so that certain social groups are not disadvantaged.

54. **Technology and equipment.** Policy changes that have the effect of subsidizing imported machinery would stimulate domestic engineering industries and machine shops, which are potentially important in helping small-scale enterprises improve their equipment. Efforts should be made to tap as far as possible the know-how and expertise possessed by domestic manufacturers of machinery and equipment. International transfer of appropriate technology may be stimulated by encouraging (through fiscal and other incentives) foreign technology suppliers to establish national agencies which can identify local needs better and provide a closer after-sales service to clients. Prototypes may be developed in collaboration with private engineering firms which can test new designs in actual production conditions and would have the commercial motivation to disseminate technological innovations to their customers in the handicraft and small-scale industry sectors. The setting up of bureaucratic "inventories" of technologies needs to be avoided; these inventories quickly become out of date and often fail to answer the specific questions of prospective purchasers. Assistance may be given in order to put small-scale producers in touch with technological suppliers (through lists of addresses and telephone numbers) so that they can discuss their mutual needs directly. Technology diffusion may be encouraged by eliminating the anti-subcontracting bias of tax policy (e.g. by substituting value-added taxes for cascading turnover taxes).

55. **Building and utilities.** Industrial estates are valuable to small enterprises but are generally subsidized and are sometimes built above the necessary standards. Removing the subsidies, levying charges adequate to

recover costs and thereby permitting wider replication, and adopting appropriate, more modest standards is likely to produce economic rewards in the long run. "Sites and services" programmes for small enterprises, under which they build to their own specifications, are also useful.

56. **Advisory services.** Advisory services are needed but should be charged for on a full-cost basis so that the providing agencies - or consulting firms - have ready evidence, from the market, of their utility. Public technical assistance institutions are more likely to be useful and responsive if they are specialized than if they seek to cover all areas of need. Also, their utility is more likely to be assured if their intended beneficiaries are adequately represented on their governing bodies.

57. **Markets.** The demand for SME products and services would be increased by eliminating "unfair" competition in the form of subsidies given to large-scale industry. The trading companies which market the products of small firms often face barriers, which should be removed. Export markets can be tapped more fully by ensuring that small firms as well as large ones benefit from import duty rebates or exemptions on imported materials and components that are incorporated into exported products. Governments can also directly enlarge the markets for small firms by sub-contracting maintenance and repair services that public agencies might otherwise perform themselves and including them in procurement schemes.

58. **Marketing.** Private traders need to be treated as allies rather than enemies of small-scale producers. By harnessing the energies, motivations, marketing know-how, consumer intelligence, stock-holding capacities, and distribution channels of wholesalers and retailers, the "supply-side" activities of service institutions will be assured of an adequate response from the demand side. Support programmes need to be focused on activities which have significant economies of scale but cannot be afforded by individual producers or traders; examples include market research for broad product groups, export studies, development of new product designs incorporating international fashion trends, and promotion of a favourable country "image" in international markets.

59. This list is not, of course, exhaustive. The best environment for SMEs is a relatively open and competitive market that provides equal incentives and opportunities for all enterprises, i.e. an economic climate combining minimum regulation with maximum openness. Support programmes focused specifically on SMEs can be useful provided they reinforce and supplement private sector initiatives, rather than replacing them. (Table 1 above provides examples of the range of support programmes that may be created). But the primary need in most countries is simply to remove the biases and obstacles facing SMEs that are implicit in existing incentive and regulatory systems.

IV. HUMAN RESOURCES DEVELOPMENT

60. It has been remarked that enterprises are human resources. Of all the fundamentals that the high-performing Asian economies have got right, their investment in various forms of education and in the creation of capabilities to underpin their drive towards developing and upgrading their local industries, with some of them moving into high-technology and high value-added activities, must rank as one of the most important ones. By investing in universal basic education, extending compulsory education to at least six and sometimes nine years of schooling, they have created a productive low-cost, semi-skilled labour pool. This has been essential for their development of competitive, export-oriented industries, like textiles and electronic products. These industries have helped to raise income levels and also to reduce income inequalities, helped, inter alia, by better wages in export-oriented manufacturing industries. They have also provided an important industrial base for industrial diversification and upgrading, particularly as these countries have succeeded, through appropriate policies, in generating a high level of domestic capital accumulation and investment and, in some cases, also encouraging and attracting a high level of foreign investment.

61. Further, as the economic situation improves and as individual incomes rise, there is higher household discretionary income to save and invest, and families are able to give their children higher or technical education in universities or in specialized technical or vocational institutions. Moreover, as inter-firm and market networks develop, the self employed providing services or products to larger firms and enterprise employees are able to learn new skills through in-firm training programmes or through the benefits of the "demonstration" or "learning by doing" effect of working with other firms using more advanced skills and technology.

62. All this has helped to raise the level of skills and capabilities, which in turn, together with a confidence-creating business environment, has helped to attract new investments, including investments involving original equipment manufacture (OEM) arrangements. Such arrangements are particularly conducive to the development of technology and skills, since they involve the close monitoring of standards by the licenser, intensive staff training and the acquisition of international marketing expertise by the licensee. The firm Samsung from the Republic of Korea entered into such an arrangement through a joint venture with the Japanese firm Sanyo in 1969 and has since then developed its own range of electronic products.

63. The above case is similar to another example involving another electronics firm in the Republic of Korea, namely Anam, currently the largest semiconductor packaging firm in the world, in terms of illustrating the various stages in the development of technology and skills in developing countries. In such a process, the firm moves from (i) basic assembly of products, based on imported inputs, by low-cost labour and product distribution by the foreign partner; to (ii) the internalization of process engineering capabilities, through the development of engineering and R & D capacity and projects and of in-house training; to (iii) the development of marketing, sales and product monitoring capacity; to (iv) the development of product design and innovation capability; and finally to (v) the development

of independent marketing and distribution channels. However, the point about OEM arrangements or the process described above is that the domestic firm must be able to provide a labour force with a minimum level of skills, in addition to other incentives like low labour costs and management overheads. Further, capabilities need to be developed for mastering techniques, which implies not only "know-how" but also "know-why", and for undertaking project management and engineering, internalizing technology and undertaking innovations (not so much producing new inventions as mastering acquired technology and adapting it to local user needs). 21/

64. Thus, various levels of skills and capabilities are needed if developing countries want to avoid being caught in a "low-technology equilibrium trap" and to compete in an increasingly knowledge-driven global economy. The high proportion of university students enrolled in science and technology in the high-performing Asian economies, for example, 60 per cent in Singapore, 46 per cent in Hong Kong and 42 per cent in the Republic of Korea, 22/ is a further illustration of the importance which they attach to the development of technological capabilities. However, as indicated above, the development of basic skills for the shop floor is as important as the development of capabilities for mastery of acquired technology and technological innovation.

65. The development of vocational and other training programmes is another aspect of human resources development of importance to SMEs. A number of guiding principles have already been mentioned for the development of support programmes to provide vocational and other types of training (see para. 53 above). They raise various issues. Among these is the matching of educational and training programmes to the needs of the business world, including the constant upgrading of skills. The issue of management training also has to be addressed.

66. There seems to be a need to ensure that educational and training programmes are better adapted to the needs of firms. For example, the development of the software industry - a sector with potential for development - in several Latin American countries seems to have been constrained by courses being too general and by a lack of systems analysts (or of analysts trained in more recent programming languages), software engineers and project managers capable of increasing productivity and of transforming the industry into a high value-added sector. 23/ Further, the problem of "credentialism", that is of obtaining a degree just for its prestige, irrespective of the relevance or usefulness of the training, needs also to be addressed. It can lead to undesirable results, including the need for firms to invest in additional training for their employees or high graduate unemployment.

67. One problem may be the lack of consultation between the vocational training institutions and the private sector. In this regard, a model developed in Latin America would seem to merit consideration. Its essential features include: autonomy from the formal educational system, thus ensuring its relevance and flexibility; financing through enterprise payrolls, which contributes to stability; and a tripartite system of governance, involving the Government, business and trade unions, which ensures accountability. 24/ Such training can be provided à la carte, so to speak. In one particular example, training is based on periodic analyses of the type of market demand

for skills and of the requirements of different occupations in related industries. Learning is organized into modules, which students complete at their own pace. While no lectures are given, guidance and testing are provided. Admission is on a continuing basis. Such training may meet the need for the constant upgrading of skills, although quite often in-firm training is provided for this purpose. The constant upgrading of skills is particularly important in terms of meeting the needs of flexible specialization.

68. The development of management skills also needs to be addressed. It has been suggested that management deficiencies, including in such areas as accounting, project supervision and strategic decision-making, explain to a large extent the lack of entrepreneurial success in some developing countries, particularly in the case of SMEs. 25/ Examples quoted include SMEs in the automotive industry in Brazil and SMEs in the metalworking industry in Zimbabwe, which have been slow to adapt to new techniques for modernization due to a lack of knowledge of these techniques. 26/ In another example quoted, that of a tyre company in Ghana, the company, when it reverted to national ownership after the departure of the foreign controlling firm, was able to produce only four tyres per day, because the previous company failed to provide adequate management training, including in the area of production techniques. 27/ On the other hand, proper training in order to expose managers and entrepreneurs to new techniques through a process of "learning to learn" has yielded positive results. An example quoted is the Programme for Entrepreneurial Development in Gujarat State in India, which apparently serves as a model for more than 50 agencies in 20 other areas in India.

69. Development of entrepreneurs is also of critical importance for a dynamic process of enterprise creation and growth. EMPRETEC, a United Nations programme managed by UNCTAD in cooperation with the Department for Development Support and Management Services (DDSMS), aims at detecting entrepreneurial talent and fostering its development. The programme identifies promising entrepreneurs, provides them with training aimed at developing their entrepreneurial traits and at understanding basic business procedures, assists them in the preparation of business plans and in financing their business ventures, helps to arrange mutually beneficial connections with larger national and foreign companies, and makes available long-term support systems to facilitate the growth and internationalization of their ventures. Over 2,500 entrepreneurs in eight African and Latin American countries have benefited so far from the programme. Each country project has developed a strong and dynamic national association of entrepreneurs, supported by a coalition of bankers, established local business people and representatives of foreign companies. The programme has evolved to a stage where there is active cross-border investment and alliances between entrepreneurs in each of the two regions and an emerging process of interregional networking and business links.

70. In a new approach to the development of entrepreneurship, Norway has recently introduced various entrepreneurship educational schemes at the primary, secondary and university levels. The main objective is to encourage innovative education and to turn the school system into a producer of creators

of jobs. This is done by integrating entrepreneurship and business training into the educational system at all levels, thus giving students a better knowledge about entrepreneurship and a greater motivation to start their own businesses. Training is adapted to local conditions and the business environment in the context of a permanent form of cooperation between the educational authorities and enterprises. Moreover, the participation of schools in local development has become part of Government policy for encouraging innovation and entrepreneurship. 28/

V. MICRO-ENTERPRISES IN DEVELOPING COUNTRIES

A. Characteristics of micro-enterprises

71. The role of micro-enterprises (defined as firms with up to nine employees) in development strategy is receiving increasing attention, including by donors, because they are seen as instruments of "participatory development", enabling a wider population, particularly the poor, to participate in the process and benefits of development. Quite often they are also identified with the informal sector and it is argued that they need to be targeted for assistance so that they can join the mainstream of national economic life, with benefits not only to the micro-enterprises themselves but also to the economy as a whole in terms, for example, of increased corporate tax revenue and competition.

72. However, they form a very heterogeneous group and, in many countries, not much is known about them, either because of a policy of benign neglect or because many of them choose and manage to stay out of the formal system of regulations and taxes. Many of them are one-employee firms (the owner himself), for example the main street cobbler/shoe shiner, the taxi owner-driver, the corner food hawker, etc. Not all micro-enterprises, though, fall into the informal sector. As indicated in an OECD study, 29/ the majority of micro-enterprises comply to some extent with registration and licensing regulations. In Thailand, although only 20 per cent of the micro-enterprises are registered, 60 per cent of them pay taxes. Moreover, not all enterprises in the informal sector are micro-enterprises. Nevertheless, informal or not, micro-enterprises remain a highly "invisible" sector, poorly documented and hence inadequately taken into account in policy-making. The need for research on a profile of the micro-enterprises in a country is therefore all the more important if the targeting of assistance is to be effective.

73. Micro-enterprises are characterised by labour-intensive activities, low wages, technology and capitalization, part-time and piece-work practices, predominance of family labour and apprenticeship, and significant participation of women, both as entrepreneurs and as workers. One micro-enterprise lending institution focuses its efforts on women because "the first thing that happens when a woman earns money in Bangladesh is that she can afford to collect her children, who, for financial reasons have usually been sent to live with other people. She then spends most of the additional income on food, housing and schooling". 30/ Supporting women microentrepreneurs can thus be a useful vehicle for promoting social change. Most micro-enterprises are located in rural areas (with populations under 20,000) and produce light consumer goods such as clothing, furniture, food and beverages, tools and equipment that are sold directly to local households. The bulk of micro-enterprise clients, between 80 and 90 per cent, come from the poorest members of society for whom micro-enterprise goods and services are the only affordable ones. 31/ Thus, micro-enterprises perform a social service by catering to the needs of this social group. Other sources of income, although accounting for only a small proportion and highly unstable, are from subcontracting and public contracts. Subcontracting is normally given to the larger micro-enterprises, those with over three workers. The contracting firms are typically SMEs who rely on micro-enterprises to help

meet deadlines in production or who contract out specific tasks such as ironing, folding and packing clothes. Micro-enterprises are particularly exposed to fluctuations in demand due to their direct contact with final consumers from the poorer levels of society, the difficulties in winning public contracts and the fact that a decline in demand for SME goods and services is first passed on to the micro-enterprises subcontracted by them.

74. Micro-enterprises provide jobs for a large section of developing country populations. One study puts the figure at about 50 per cent of total industrial employment, but it defines micro-enterprises as firms employing up to 50 workers, although most of the firms surveyed had less than 10 employees. 32/ However, many of their jobs are part-time and very insecure. There is only work when there is demand. Workers are often simply subsisting on part-time salaries with no social security, insurance or pensions. Micro-enterprises try to cut costs by minimizing expenditures on safety devices, lighting and sanitation, not to mention anti-pollution measures, resulting often in dangerous and shoddy working conditions.

75. However, on the other hand, micro-enterprises are perhaps the best way to integrate marginalized elements of society, making full use of human energy and initiative and encouraging entrepreneurship, as indicated above.

B. Assistance to micro-enterprises

76. Micro-enterprise assistance is moving from a focus on short-term, specific projects to an emphasis on longer-term institution-building. Policy reform can be used to construct an environment favourable to micro-enterprise development and to reinforce institutions dealing with micro-enterprises.

77. Such assistance may include a variety of measures, as discussed below.

78. **Regulatory reform.** Aspects of the regulatory framework which affect micro-enterprises include registration and licensing requirements, zoning regulations, public health and safety standards, labour laws and taxation. The location, activity and size of the micro-enterprise also matter. Compliance tends to be higher in urban districts, where there is greater control, than in rural areas, as well as in establishments such as restaurants which can affect public health and the tourist trade than in other less exposed firms. Larger micro-enterprises comply more readily with regulations than the smaller ones, because they are too large to escape detection and because they can afford to do so. Surprisingly, the majority of micro-enterprises comply to some extent with the regulations. Regulations whose benefits are clear and easily understood are more willingly accepted. The benefit of health and safety standards is obvious, so that micro-enterprises often comply. Location and siting restrictions, on the other hand, can often deny prime sites to micro-enterprises and thus arouse opposition.

79. Registration of micro-enterprises is crucial for gathering information that can lead to more effective policy-making. In order to ensure wide compliance, the paperwork and the cost should be reduced to a minimum. It should be viewed as an information-gathering rather than as a revenue-raising exercise, and thus separated from the Ministry of Finance.

80. Labour regulations would seem to be widely ignored in micro-enterprises. Enterprises sidestep the minimum wage by exploiting the status of apprentices, paying by piece, demanding overtime without payment and using numerous other methods. Entrepreneurs point out that, while they may not comply with all the labour regulations, they help to develop human resources by engaging and training often uneducated and unskilled workers who would otherwise not have found employment. Further, apprentices and workers are often family members or friends or people recommended by them. Entrepreneurs also claim that they give loans to their workers for family emergencies, pay for hospitalization and medication and allow their workers to tend their fields at harvest time. Rather than lowering the minimum wage, a longer-term policy programme to change the quality of labour would be more effective. This may include, among other things, mandatory schooling to reduce illiteracy and most of all government-sponsored training programmes to give workers the skills they need to command a better wage and to defend their rights.

81. The case of Ecuador may serve as a model for reform. Here, micro-enterprises enjoy a special status and certain advantages (special loans, special provisions for the workforce, advantages on the market compared to large enterprises, etc.) if they are registered, but once registered they cannot avoid paying taxes. However, tax exemptions are given to some micro-enterprises - generally those unable to afford it - permitting micro-enterprises to operate formally without worrying about taxes. 33/

82. Other measures for tax reforms may include improving public administration, providing tax exemption for the initial years of operation and, above all, making sure that the tax system reflects the nature of the micro-enterprise sector. Micro-enterprises often complain that they do not see any corresponding benefits from their tax payments. This may imply forgoing taxes on independent entrepreneurs who cannot afford to pay, not insisting on formal accounting, for which micro-enterprises often do not have the skills or time to undertake, and taking into account the highly variable nature of micro-enterprise income.

83. **Access to credit.** In terms of financing, several alternative institutions have demonstrated that loans to micro-enterprises can be cost-effective and that micro-enterprises can be good credit risks. In order to accomplish this, financial institutions have to rethink conventional notions regarding, for example, loan procedures. Promotion is particularly important to reach microentrepreneurs who are often in rural areas or working from their homes with little experience of formal institutions. Decentralisation of the institution's structure is necessary in order to reach rural clients more effectively. K-REP in Kenya sends credit officers into villages to familiarize themselves with potential clients who in turn can help them organize client groups for a group lending scheme. The Grameen Bank in Bangladesh sends its staff door-to-door. It has a one-year training programme during which staff must write two detailed case studies on borrowers in the rural areas, resulting in staff who are attentive to the needs of microentrepreneurs.

84. Relying on savings groups and encouraging savings can help to build up funds for lending to micro-enterprises. Some development banks and NGOs have a savings requirement for loans. The savings are used in case of default.

This also gives clients a place to keep their money and introduces them to formal financial institutions. Governments can help authorized micro-enterprise lenders by deregulating interest rates and by according them the right to accept deposits. Group lending has proved to be quite efficient in several countries. Members of a group (usually between five and eight members) pool their savings. They establish their terms of lending and submit them to the lending institution, which then makes a loan to the group. The loans normally rotate so that only one member of a group can borrow money at one time; the loan must be repaid before another member can borrow. Group members will only lend to those who can be trusted to pay back, otherwise they will lose their own chances of borrowing and, as they are collectively responsible, their creditworthiness. Thus, peer pressure takes the place of the traditional collateral. Small loans reduce the risk for lenders. Loan sizes can be increased with each successful repayment, giving borrowers an incentive to repay. Simplifying loan procedures, together with help provided by bank staff, is also important. The SEWA Bank in India requires only a thumb print and two copies of a photograph instead of a signature, facilitating the process for illiterate clients. The procedure itself should be rapid. Most micro-enterprise lending institutions take from a few days to a maximum of two weeks to clear a loan. Charging clients market interest rates in order to recover the cost of each loan would help financial institutions become self-sufficient, while still offering credit below the price of informal money lenders. Becoming self-sufficient is an important step for micro-enterprise financial institutions to move closer to the formal sector.

85. **Access to information**. Better access to information is very important for the promotion of micro-enterprises. Many micro-enterprises do not comply with regulations because they are unaware of such regulations or of their contents. Access to credit, training workshops and other forms of aid to micro-enterprises should be better advertised, so that micro-enterprises can benefit from these programmes.

86. It may be noted that microentrepreneurs are increasingly organizing themselves at the grassroots level into self-help groups, enabling microentrepreneurs to articulate better their needs and issues. Starting out as savings associations, such groups now include producer groups, cooperatives and indigenous business associations. These self-help groups, in addition to providing mutual assistance, can serve as useful partners for the organization and delivery of support programmes. For example, incorporating these groups enables donors to localize micro-enterprise support programmes, as in the Port Sudan Urban Programme, in which local business persons are hired to teach business courses, as opposed to bringing in outside experts. Not only do the locals understand better the workings of the local business environment, microentrepreneurs are also more comfortable in dealing with locals. Promoting grassroots participation leads to projects designed from below and so more pertinent to the needs of microentrepreneurs.

C. Transition to the formal sector

87. The advantages of moving into the formal sector are that micro-enterprises can expand their businesses, increase their income due to the possibility of winning public contracts and finding work as

subcontractors, and obtain better access to credit facilitates. However, it should be recognized that many of the advantages of micro-enterprises stem from the fact that they operate on a small scale and that these advantages may be lost when they expand. It is possible that micro-enterprises do not expand or do not wish to expand simply because their client base and operations are very particular. Many micro-enterprises start out as a means of survival or of supplementing family income, with expansion not even a consideration. Once an entrepreneur is able to feed herself and her family, and perhaps afford a few comforts, there is no incentive for her to expand or to join the formal sector. Running a dressmaking operation at home is hardly the same thing as opening a tailoring shop. As a result, micro-enterprises tend not to expand, remaining largely unchanged in size over time. In Thailand, a survey showed that only 10 per cent of enterprises over two years old have hired more workers during the past two years. 34/ Further, a survey of entrepreneurs with larger enterprises (with over 10 employees) revealed that they were in general younger than microentrepreneurs and better educated. Most of them did not expand from a small enterprise, but rather started out as a larger firm. This would seem to indicate that better education is the key to enabling the micro-enterprise sector to expand and join the formal sector. 35/

88. Micro-enterprises play an important role in linking traditional and modern production systems, agricultural and industrial sectors, and rural and urban areas. These linkages are particularly important for the development process. Apart from regulatory reform and support programmes to help micro-enterprises, which may facilitate their transition to the formal sector, programmes to promote basic education and to increase the level of skills would probably prove most effective in terms of promoting the integration of micro-enterprises into the formal sector, without destroying some of the economic and social functions that they are now performing. At the same time, measures may be taken to encourage subcontracting arrangements with micro-enterprises and allowing "graduated" micro-enterprises access to public contracts. One example of this type of programme was the AGETIP (l'Agence pour l'Exécution de Travaux d'Intérêt Publics contre le Sous-emploi) project in Senegal. The primary goal of this joint project between the World Bank and the Government of Senegal was to alleviate unemployment. The areas covered included construction works of economic and social benefit such as the renovation of schools and clinics, the cleaning and construction of storm drains and the improvement of road conditions. 36/ Such measures can help not only to reinforce the linkages mentioned above but also to provide incentives to micro-enterprises to join the formal sector.

Notes

1/ The definition of small and medium-sized enterprises varies among countries, with the upper limit for manufacturing enterprises going from 99 to, for example, 1,499 employees, in the petroleum-refining industry of the United States. Some countries also have a separate upper limit for services, invariably less than for manufacturing. Other criteria are also used, including total assets or sales. The definition is obviously policy-specific in the sense of determining a "cut-off" point for assistance.

2/ See: EIM Small Business Research and Consultancy, European Observatory for Small and Medium-sized Enterprises.

3/ See: World Bank: Trade and employment policies for industrial development. Washington D.C., 1982.

4/ Employment performance. McKinsey Global Institute. Quoted in: Financial Times, 18 November 1994.

5/ See: ECE: Small and Medium-sized Enterprises in the ECE Region. (TRADE/R.586). Geneva 1992.

6/ See: Khatkhate, D.R.: The Regulatory Imperatives to Private Industrial Sector Development: A Comparative Study. (World Bank Discussion Paper, No. 177), Washington D.C., September 1992.

7/ See: Amsden, A.: Trade policy and economic performance in South Korea. In: Agosin, M./Tussie, D. (eds.): Trade and Growth: New Dilemmas in Trade Policy. Basingstoke and London: Macmillan; New York: St. Martin's Press, 1993.

8/ Y. Yonezawa: National economic independence and the rationalization of industry. In: J. Teranishi/Y. Kosai (eds.): The Japanese Experience of Economic Reform. London: Macmillan 1993, p. 251.

9/ See: Shafaeddin, S.M.: The impact of trade liberalization on export and GDP growth in least developed countries. UNCTAD Discussion Papers No. 85. Geneva 1994.

10/ See: Government of Mauritius: Country contribution to the Ad Hoc Working Group on the Role of Enterprises in Development. Geneva 1995.

11/ See: World Bank: The East Asian Miracle: Economic Growth and Public Policy. Oxford University Press, 1993.

12/ See: Dunning, J.H.: Globalization, Economic Restructuring and Development. (The 1994 Raul Prebisch Lecture, UNCTAD/EDM/ERCP/7). Geneva 1994, p. 26.

13/ de Wilde, T./Schrenvs, S./Richman, A.: Opening the Marketplace to Small Enterprises, 1991.

14/ ILO: Study on the Government Agencies Providing Assistance to the Handicraft and Small-Scale Industry in Sri Lanka, Geneva 1991.

15/ See: Economic Development Board: Growing with Enterprise - a National Effort, Singapore 1993.

16/ See: Govt. of Norway: Country contribution to the Ad Hoc Working Group on the Role of Enterprises in Development, Geneva 1995.

17/ See: Govt. of China: Country contribution to the Ad Hoc Working Group on the Role of Enterprises in Development, Geneva 1995.

18/ See: Amsden, A.H.: Asia's next giant: South Korea and late industrialisation, 1989.

19/ Marsden, K.: African Entrepreneurs: Pioneers of Development. (IFC Discussion Paper 9) Washington D.C., 1990.

20/ This section includes some recommendations contained in: ILO, op. cit.

21/ See: Dahlman, C.J./Ross-Larson, B./Westphal, L.: Managing technological development: Lessons from the Newly Industrialising Countries. In: World Development, Vol. 15, No. 6, 1987.

22/ See: Lall, S.: Building industrial competitiveness in developing countries. OECD 1990.

23/ See: Correa: Software industry: An opportunity for Latin America. In: World Development, Vol. 18, No. 11, 1990.

24/ See: Middleton, Ziderman and Adams: Vocational and technical training. World Bank Policy Paper, 1991.

25/ See: Anderson, D.: Small industry in developing countries: A discussion of some issues. In: World Development, Vol. 10, 1992.

26/ See: Marx, R.: Quality and productivity in small and medium sized firms in the Brazilian automotive industry. In: IDS Bulletin Special Issue, Vol. 24, No. 2, April 1993.

27/ See: Adei, S.: Technological capacity and aborted industrialisation in Ghana: The case of the Bonsai Tyre Company. In: World Development, Vol. 18, No. 11, 1990.

28/ See: Government of Norway, op. cit.

29/ See: OECD: New Directions in Donor Assistance to Microenterprises. Paris 1993.

30/ See: Best Practice in Financial Services to Microentrepreneurs. In: What Works. A Women's World Banking Newsletter, Vol. 4, No. 2, April 1994, p. 6.

31/ See: Morrisson, Ch./Solignac Lecomte, H.-B./Oudin, X.: Microenterprises and the Institutional Framework (OECD Development Centre Studies), Paris 1994, p. 57.

32/ See: Liedholm, C./ Mead, D.: Small-scale enterprises: A Profile. In: Economic Impact, No. 63, 1988/2, p. 12.

33/ See: Morrisson et al., op. cit.

34/ See: Morrisson et al., op. cit., p. 214.

35/ See: Morrisson et al., op. cit., pp. 217-218.

36/ See: OECD, op. cit.